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C O N F I D E N T I A L SECTION 01 OF 02 RIGA 000191

SIPDIS

TREASURY FOR DAVID WRIGHT AND ERIC MEYER

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TAGS: ECON EFIN PGOV LG
SUBJECT: LATVIA: IMF PUTS PAYMENTS ON HOLD UNTIL GOVERNMENT BUDGET APPROVED

REF: RIGA 125

Classified By: Charge d'Affaires a.i. Bruce Rogers, for Reasons 1.4 (b) and (d)

¶1. (C) Summary. The International Monetary Fund (IMF) has delayed its next installment of financial aid to Latvia until the government completes its budget amendments. The IMF has also underscored to the government that its efforts to date do not constitute the needed structural reforms. The government has pushed back plans to complete its budget proposals until June 9, three days after local government and EU parliament elections. The delay is potentially a good sign that the government and political party leaders understand that painful reforms and budget cuts must be enacted, and are prepared to undertake a strategic review of government programs and spending, rather than the mechanical cuts made to date. Additionally, the June date may help take the budget cuts out of the election debate. That could backfire if some parties fare poorly in local elections and see no need to continue acting responsibly in the government. End summary.

¶2. (C) The Finance Ministry announced April 2 that the IMF was suspending further disbursement of its financial assistance to Latvia until the government completes amendments to the federal budget. Both the Finance Ministry and Bank of Latvia downplayed the significance of the payment shut-off, with the Bank of Latvia noting that it is common for IMF assistance to be suspended at periods during a review, and both agencies stressing the sufficiency of Latvian central bank and treasury reserves to keep the government going in the near term. A key Bank of Latvia official told us that the government has accepted the fact that Latvia will not be able to negotiate an increase in the budget deficit the country can run under the IMF and European Commission (EC) aid packages, and that they are currently aiming to stay within the 5 percent of GDP budget deficit limit dictated in the assistance agreements. Throughout March, both the PM and Finance Minister publically declared their desire to negotiate higher budget deficits (7 to 9 percent of GDP), and at the onset of the last IMF visit, the PM even made public comments regarding the IMF's "openness" to possible devaluation of the Lat (made possibly in hopes of creating a split between IMF and EC enforcement of the aid package requirements and gain EC financing of a larger deficit). However, after meetings with the IMF and EC in the last weeks, the government has realized that permission and financing for an increased budget deficit is not forthcoming, according to the Bank source.

¶3. (C) The government has announced that it will work to submit on June 9 an 18-month budget plan that will get the budget on target to meet the 3 percent of GDP deficit goal for 2011, which is necessary to meet the Maastricht criteria for Latvia's entry into the Euro-zone. Bank of Latvia Governor Rimsevics has been very vocal in the press stating

that if Latvia fails to meet the Maastricht criteria in 2011, another opportunity to adopt the Euro may not come for years, as inflation may rebound after 2011. To achieve this year's 5% deficit goal, the government must find another 700 million Lats (roughly $1.5 billion USD) in budget reductions, as government revenues continue to shrink. The PM has directed ministries to develop budget proposals for 20%, 30% and 40% budget decrease scenarios so that the government can make decisions about cuts in each ministry. New government-wide standards on staffing and expenditures have also been proposed.

¶4. (C) Bringing the government around to facing its budget reality was apparently greatly aided by the late-March visit of the IMF's deputy representative for Europe, Mark Griffiths. In meetings with post, he described his frustration with the government's previous inaction on budget reforms and outlined the hard line he would be taking on Latvia's need to meet the IMF requirements it had agreed to. In assessing the government's request to run a larger-than-allowed deficit, he likened Latvia to a child who brings home a report card of straight F's, and then asks for a new PlayStation. He said he stressed in all his meetings with the government the need for Latvia to start thinking strategically and prioritize cuts, and stop working backwards from a deficit figure. He also noted that he was prepared to recommend to the IMF Board that the Fund walk away from assistance to Latvia if the government insisted on running larger deficits.

¶5. (C) Comment: The key obstacle to prioritizing budget cuts between ministries is Latvia's coalition government

structure. In putting together a ruling coalition, the political parties agree on a division of the ministries between coalition partners, and then defend the ministries they control and compete for budget funds. As no party is willing to admit that the activities of one of their ministries are less essential to the country, the only politically-palatable way to impose budget cuts has been to make across-the-board reductions. Until the political parties are willing to share burdens in a strategic manner, no prioritizing of cuts is possible.

¶6. (C) Comment cont'd: Given what appears to be government acceptance that they must live within the limits of their previous agreements with the EC and IMF, the delay of budget amendments until June 9 may be a positive sign that the government is taking the time to do cuts right, and by setting the date after local elections, is trying remove the budget as an election issue. The price they pay immediately is the announced suspension of IMF disbursements, but the government points out that they have reserves enough to function into summer. The possible downside of waiting until after elections is that if coalitions members such as the Peoples' Party (TP) or Greens and Farmers (ZZS) are decimated in the local elections, they may have no motivation to act responsibly in an austerity-mode government. To regain appeal with voters, they could possibly adopt a more populist approach or even break from the coalition. We are cautiously optimistic that the additional time spent preparing the budget will yield a worthy proposal of long-term benefit to Latvia.
ROGERS